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E.O. 12958: N/A
TAGS: ECON ETRD EIND EFIN RO
SUBJECT: ROMANIA: NEW GOVERNMENT INAUGERATES FISCAL REVOLUTION WITH ADOPTION OF FLAT TAX

RE: Bucharest 01873

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¶1. (SBU) SUMMARY: Just before New Year's eve, and the day after receiving Parliament's vote of confidence, the new center-right government of PM Calin Popescu-Tariceanu carried out its campaign pledge to amend the Fiscal Code and introduce a 16% flat tax on personal income and corporate profits. The new tax rate was effective January 1, 2005. The IMF is concerned that the measure may result in the GOR's not meeting this year's programmed budget deficit target of 1.5% of GDP. The Government is counting on new revenues from both the hitherto untaxed gray economy and from economic growth. Measures to increase tax compliance must still be enacted, but legal actions just taken against some of the most dubious objects of economic largesse of the last Government may have a salutary impact on revenue collections. END SUMMARY.

ROMANIA JOINS THE FLAT TAX CLUB

¶2. (U) One of the main pledges of the center-right Liberal-Democratic (PNL-PD) alliance throughout the autumn parliamentary and presidential campaign was to introduce a flat tax of 16% on personal income and corporate profits. On December 29, in the first cabinet meeting after receiving a Parliamentary vote of confidence, the first major act of the new PNL-PD led government was to enact the measure through an emergency ordinance effective January 1, 2005. Prime Minister Calin Popescu-Tariceanu and the new Finance Minister Ionut Popescu declared that the purpose was to put more money in Romanian taxpayers' pockets, create more jobs and stimulate foreign direct investment (FDI). Through the "multiplier" effect generated by increased employment and greater disposable incomes, the Romanian government expects to collect more tax revenue over time. In addition, the GOR hopes to reduce tax evasion and bring more money into national coffers through "surfacing" the underground (gray) economy, in which many workers receive unreported, untaxed wages. (Note: The last Government estimated a full quarter of the economy was represented by the informal or gray economy in 2004.

¶3. (U) Romania is not the first country in Eastern Europe with a flat tax. According to information available to post, Estonia, Latvia, Serbia, Ukraine, Slovakia, Russia, and most recently Georgia have adopted flat tax rates ranging from 12 to 26%. Romania's 16% corporate tax is the region's second lowest (Georgia's is 12%), while only Russia (13%) and Georgia (12%) have lower flat tax rates on personal income.

GOVERNMENT MESSAGE: EVERYONE WINS, NO ONE LOSES
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¶4. (U) The Government promises that no employee will lose through replacement of the former personal tax brackets (which ranged from 18-40%) with the new 16% flat tax. Under the flat tax, the main deduction an employee receives are the personal and dependent deductions. For employees earning up to a gross monthly wage of ROL 10 million ($345), the deductions range between ROL 2.5 million ($86), for those with no dependents to ROL 6.5 million ($225), for a wage-earner with four or more dependents. Deductions are gradually lowered for employees with gross monthly wages between ROL 10 and ROL 30 million ($1,037), with no personal deductions for those with gross monthly wages exceeding ROL 30 million. Other deductions preserved include private health insurance (up to euro 200 per year per person), social security contributions, optional contributions to occupational pension schemes (life insurance, up to euro 200 per year) and expenditures for employees carrying out independent activities (commerce or professions such as lawyers, medical doctors).

BUSINESS HAPPY, LABOR COMPLAINS

¶5. (U) The business community's reaction was predictably enthusiastic. Both the American Chamber of Commerce in Romania and the Foreign Investor's Council hailed the measure as a step forward toward creating a stable and predictable tax environment for investors. Trade union leaders, however, denounced the flat tax as "socially unfair," disproportion ally benefiting wealthy taxpayers. The former governing Social Democratic Party (PSD) similarly characterized the flat tax as a "political measure," claiming the flat tax will lead to major medium and long term problems for the budget and will have to be compensated by either raising excise taxes or by drastic budget cuts.

FISCAL IMPLICATIONS SUBSTANTIAL...

¶6. (U) According to Finance Minister Popescu's estimate, the budget revenue losses could amount to $242 million from the profit tax cut and $830 million from the 16% flat income tax. While conceding a transition period of budget revenue losses, the Finance Minister is optimistic that budget revenues will ultimately increase, as has happened in other countries that have adopted a flat tax.

...SOME TAXES SET TO RISE

¶7. (U) To compensate for these projected losses, the new Government introduced a series of tax hikes. The micro-enterprise tax, applicable to firms with nine employees or less, was doubled from 1.5% to 3.0% of total turnover. According to the Finance Minister, the doubling of the tax paid by mico-enterprises is an attempt to uncover personal incomes disguised as micro-enterprise revenues. A significant number of these enterprises are organized to circumvent payment of employee-employer payroll taxes through "spinning off" operations into micro-enterprises for favorable tax treatment.

¶8. (U) Other tax increases include:
Dividends obtained by individuals will be taxed at 10%, level with the corporate dividend tax;
- Agricultural income tax is increased from 15% to 16%;
- Gambling tax is increased from 10% to 16%.

¶9. (U) Despite the fact that the former PSD government approved a 2% cut in payroll taxes for 2005, the new government annulled this measure, maintaining social insurance contributions at 49.5%. The downside to this is with social contributions remaining high, a strong incentive remains for employees to continue working in the untaxed "gray" economy.

IMF'S CAUTIOUS REACTION

¶10. (U) The IMF initially expressed concern regarding the GOR's recent fiscal step. The IMF resident representative met with Finance Minister Popescu prior to the cabinet meeting of December 29, 2004. He conveyed the message that the 1.5% of GDP deficit for 2005 is the maximum Romania can afford and perhaps should be decreased in order to ensure Romania meets inflation and current account deficit targets. He also advised the GOR to refrain from taking any step prior to the visit of the IMF's technical team scheduled for January 25. Nevertheless, he conceded the new Cabinet's move to introduce the 16% flat tax was in line with regional trends to reduce taxation. He subsequently softened his position, noting that the IMF visitors would examine budgetary implications.

REFORM BY DECREE - THE MECHANISM

¶11. (U) The government introduced the flat tax on December 30, 2004, through Emergency Ordinance 138 to Law 571/2003 of the Fiscal Code. In the preface to the ordinance the Government stated it was necessary for the measure to take effect at the beginning of the year (2005), because waiting until later would result in fiscal confusion and uncertainty for taxpayers and complicate tax collection.

¶12. (U) Two issues cloud the issuance of the emergency ordinance. Formal consultations with the Social and Economic Council (CES), required before passage of emergency ordinances, did not occur as the CES was on vacation. However, the new Government stated it had received the CES's approval "in principle." Secondly, as with all emergency ordinances, the flat tax measure will ultimately have to be ratified by the Parliament at a later date. Parliament could ultimately reject the flat tax, although this is unlikely given the current majority held by the Government.

COMMENT

¶13. (U) The new GOR's ordinance has positive and negative implications for the new government. On the positive side, it demonstrates the Tariceanu government's commitment to keep its election promises to cut taxes to improve living

standards and build a more business friendly environment. Further, the new government's tax philosophy makes sense as long as the 2005 tight budget deficit (1.5% of the GDP) and disinflation process are not endangered. The flat tax simplifies fiscal legislation, cuts fiscal administration and collection costs, and renders the economy more transparent. On the negative side, however, there is a risk of macroeconomic disequilibria, with government revenues initially expected to decline.

¶14. (SBU) Changing the mentality of Romanians is another major obstacle. A high payroll tax (49.5% of wages) is still the main obstacle to bringing the wages actually earned, but not reported, out in the open. It will keep substantial numbers of Romanians in the "gray" economy. What is likely to be more openly reported is the incomes of self-employed persons (architects, accountants, lawyers, physicians), who might elect to pay the 16% flat income tax rather than risk being charged with tax evasion. It is significant that anti-tax dodging measures have not been put into place. Nevertheless, the average taxpayer and corporation can hardly fail to absorb lessons carried in the daily press in recent days about new indictments issued against some of the country's corrupt "big fish" who had taken advantage of favorable tax debt for shares swaps or tax holidays.

¶15. (SBU) Post does not perceive that a major problem has arisen between the IMF and the GOR regarding the flat tax or that the IMF doubts the GOR's commitment to continuing prudent fiscal policies. Nonetheless, post plans to speak with the local IMF representative to gauge IMF flexibility with the new government and report Septel.
DELARE